

by the Commission, all SFAS-106 costs above pay-as-you-go costs should be included in the calculation of the exogenous amount.

B. Issue D Item 2

If Implemented After Price Caps, But Before The Change Required By SFAS-106

If funding was implemented after price caps, but before adoption of SFAS-106 there would have been no mechanism for incremental recovery of these funding levels. Because there has been no price mechanism to allow any increased rate recovery of these funding amounts that may have occurred since the implementation of price cap regulation, none of these additional funding amounts should be subtracted from the SFAS-106 amounts to arrive at the proper exogenous amount.

To the extent SFAS-106 costs mandated by the accounting change exceed the levels of postretirement benefit costs previously included in a carrier's price cap rates, an exogenous adjustment is appropriate. The calculation of the exogenous amount should be based on SFAS-106 accounting for postretirement benefits. No additional adjustments based on funding decisions are warranted.

C. Issue D Item 3

If Implemented After The Change In Accounting Required By SFAS-106

If funding was implemented after adoption of SFAS-106 there would have been no mechanism for direct, incremental recovery of these funding levels. Because there has been no price mechanism to allow any increased rate recovery of these funding amounts that may have occurred since the implementation of SFAS-106 accounting,

none of these additional funding amounts should be subtracted from the SFAS-106 amounts to arrive at the proper exogenous amount. The calculation of the exogenous amount should be based on SFAS-106 accounting for postretirement benefits. No additional adjustments based on funding decisions are warranted.

V. ISSUE E

The Designation Order asks:

Should exogenous treatment for SFAS-106 amounts be limited to costs that are funded?²⁴

No. The response to Issue D above essentially answers this question for SWBT. Following are SWBT's responses to the specific requests in paragraph 21.

A. Paragraph 21, Item 1

Describe Any VEBA Trust Or Other Funding Mechanisms For The Expenses That Were Established Prior To The Adoption Of SFAS-106

Other than for the very small amounts associated with life insurance discussed above (and recognizing that life insurance represents only about 0.3% of SWBT's SFAS-106 accruals), SWBT made no VEBA prefunding for OPEBs prior to the adoption of SFAS-106. The absence of VEBA funding for SWBT was previously described in SWBT's 1992 Direct Case on pages 22 through 24.²⁵

²⁴ Designation Order at para. 21.

²⁵ In December 1987, SWBT established a VEBA which was used to pay medical claims for retirees and active employees. This VEBA has been utilized as a cash management vehicle for paying medical claims in the succeeding year. As such, this had no impact on long term funding of the SFAS-106 obligations. Additionally, expenses (cost of service) related to these medical claims were recognized

B. Paragraph 21, Item 2

Provide The Amounts, Placed In These Funds For Each Year Since They Were Implemented, Including The 1990-91 Tariff Year For LECs And The 1989-90 Tariff Year For AT&T

Following are the total company amounts, by year, placed by SWBT into the life insurance retirement funding account:

1987	\$ 4.4M
1988	3.4M
1989	0.8M
1990	0.6M
1991	0.1M
1992	0
1993	0
1994	0
1990/91 Tariff Year	0.4M

The amounts allocated to interstate would be approximately 25% of the above amounts. Thus, the interstate amount of funding for accrual accounting of life insurance OPEBs in the 1990/91 tariff period was approximately \$0.1 million.²⁶

on a pay-as-you-go basis. In fact, funding of medical claims for retirees through this VEBA was discontinued in March 1992. SWBT has thus not responded to items 2-5 for this VEBA as the responses would not be relevant. SWBT, however, is willing to provide the information if the Commission so desires.

²⁶ Due to this de minimis amount, SWBT has not responded to items 4 and 5 for this funding vehicle. SWBT is willing to research this information if the Commission so desires.

C. Paragraph 21, Item 3

Describe And Provide The Amounts In The Trust That Were For Ongoing OPEBs And Those That Were For TBO

Total assets in the life insurance retirement funding account for the benefit of SWBT participants as of January 1, 1993 were \$265M. This amount was not allocated between the TBO and ongoing OPEBs, nor would such an allocation be meaningful. The balance in any VEBA trust or other SFAS-106 fund at any time is meant to provide sufficient resources to provide for future obligations as they become due.

D. Paragraph 21, Item 4

Describe The Assumptions Made When The Funds Were Set Up, Including, But Not Limited To, The Time Value Of Money, Expected Long-Term Rate Of Return On Plan Assets, Future Compensation Levels, And Retirement Age Factors Affecting The Amount And Timing Of Future Benefits

See Sections V. A. and B., supra.

E. Paragraph 21, Item 5

State The Purpose Of The VEBA Funds And Describe What SFAS-106 Benefits Packages Are Covered By Each VEBA Fund

See Sections V. A. and B., supra.

F. Paragraph 21, Item 6

Describe The Restrictions, If Any, That Prevent These VEBA Funds From Being Used For Other Than SFAS-106 Benefits.

The Internal Revenue Code (IRC) levies a 100% excise tax penalty on reversions from a collectively-bargained-for VEBA. Thus, any party would experience a total loss of funds if it attempted to use the VEBA funds for uses other than SFAS-106 benefits.

VI. ISSUE F

The Designation Order asks:

Should exogenous treatment be given only for amounts associated with employee interests that have vested?²⁷

In remanding the Commission's January 22, 1993 OPEB Order, the U.S. Court of Appeals directed the Commission to decide the issue of the proper amount of exogenous treatment for SFAS-106 using the rules that were in place at the time of the adoption of SFAS-106 accounting and the LECs' original request for exogenous treatment. The issue of amounts associated with employee interests that have vested was never and should not now be added to the criteria for exogenous treatment.

The questions dealing with "vesting" and any related issues appear to be a renewed attempt to decide the amount of the SFAS-106 exogenous treatment on the issue of control over the underlying OPEB plans. A narrow focus on whether a carrier happens to retain some legal right to modify OPEB plan provisions should not be dispositive of whether rate recovery of the incremental costs that were mandated by the SFAS-106 accounting change should be exogenous.

The FASB also considered the "control" issue, concluding that there is a significant cost to the company from attempting to lower OPEBs. The following are quotes and summaries from the FASB's Statement on OPEB accounting:

The Board has looked beyond the legal status of the promise to consider whether the

²⁷ Designation Order at para. 22.

liability is effectively binding on the employer because of past practices, social or moral obligations, or customs.²⁸

An entity is considered to be obligated for these benefits unless it can avoid the future sacrifice at its discretion without significant penalty. The penalty to the employer need not be in form of a reduction in the value of assets.

It could refuse to pay only by risking substantial employee-relations problems. As a practical matter, it is unlikely that an employer could terminate its existing obligation under a postretirement benefit plan without incurring some cost. Therefore, the Board concluded that in the absence of evidence to the contrary, an employer is presumed to have accepted responsibility to provide the promised benefits. Consequently, the accounting . . . is based on the presumption that the plan will continue and that the benefits promised by the employer will be provided.²⁹

This determination by the FASB was made with the knowledge that some companies retain the legal right to modify or terminate OPEB plans. The Commission is required to look beyond the legal status of the OPEB plans to the requirement established by the courts and the practical commitment represented by the carriers' relationships with their employees and retirees:

For both types of accounting changes [i.e., GAAP changes and USOA changes], the Commission's mandate brings about the change and demonstrates that carriers lacked control.
(p. 5, bracketed explanation added)

Both sides agree that the FCC's statement of its criteria for exogenous cost treatment constituted a rule, not a policy statement.

²⁸ SFAS-106 Statement, para. 156.

²⁹ SFAS-106 Statement, para. 157.

... Accordingly, the Commission was bound to follow those statements until such time as it altered them through another rulemaking. ... Thus, the question posed by petitioners is whether the FCC adhered to those criteria in evaluating the LECs' filings on SFAS-106. We conclude that it did not. (p. 7)

There is simply no hint of such a control test in the Commission's discussion of accounting changes in either the LEC Price Cap Order or the LEC Price Cap Order on Reconsideration. (p. 8)

Accordingly, we remand to the FCC to consider the LECs' request for exogenous cost treatment of their SFAS-106 incremental costs in a manner consistent with this opinion and with the LEC Price Cap Order and the LEC Price Cap Order on Reconsideration. (p. 15)

SWBT described its relationships with its employees and retirees in its 1993 Direct Case, especially in pages 13 through 15. SWBT incorporates that evidence by reference here. These materials respond to the Designation Order's request for information on "when an employee's interest vests," although "vesting" is not the proper term to be used in explaining the relationship between SWBT and its employees and retirees.

VII. ISSUE G

The Designation Order asks:

How should the deferred tax benefit applicable to OPEBs be treated for purposes of exogenous adjustments?³⁰

SWBT made the adjustment to interstate rate base caused by the deferred tax effects associated with SFAS-106.

³⁰ Designation Order at para. 23.

The deferred income tax asset arising from SFAS-106 accrual accounting for book purposes is included as an addition to SWBT's rate base. This treatment complies with RAO Letter 20 and Subpart G of Part 65 of the Commission's Rules.

No additional adjustment to reflect the deferred income tax benefit associated with SWBT's accrual of SFAS-106 amounts is necessary because any deferred income tax benefits are exactly and equally offset by current income tax charges.

In addition, there is no overlap with exogenous adjustments for excess deferred taxes because there have been no federal tax rate changes since SWBT adopted SFAS-106 accounting effective January 1, 1993.

VIII. SUPPORTING STUDIES AND MODELS

A. Studies On Which The Company Seeks To Rely

Paragraph 24 of the Designation Order requires all studies on which the company seeks to rely in its demonstration that "these accounting changes should receive an exogenous cost adjustment."

Paragraph 24 of the Designation Order further explains that "[t]his includes studies demonstrating that the change is not reflected in the current price cap formulas, factors for inflation, productivity, allowed exogenous changes, the rates in effect on the initial date that the carrier became subject to price cap regulation, or, for the LECs, the sharing and low-end formula adjustment mechanisms." (emphasis added)

In a Direct Case filing made in this docket on behalf of the price cap LECs, USTA is filing copies of studies responsive to paragraph 24 of the Designation Order. USTA is filing these studies on behalf of a group of the price cap LECs to reduce the massive volume of duplicative paper filings that would be required if each individual LEC that seeks to rely on these studies were to file them individually. SWBT hereby explicitly incorporates the USTA Direct Case into its own Direct Case by reference.

The Godwins Study continues to demonstrate that SWBT's exogenous amounts do not contain any "double counting" in the inflation adjustment contained in the LEC price cap plan. SWBT first filed the Godwins Study as part of its 1992 Direct Case in CC Docket No. 92-101. SWBT again relied on the Godwins Study in its 1993 Annual Access Tariff Filing (in which, under protest, pending court appeal and at the invitation of the Commission in its January 22, 1993 OPEB Order, SWBT included only the TBO amount in its exogenous amount). SWBT relied on the Godwins Study again in its 1993 Direct Case in CC Docket No. 93-193 and then in its 1994 price cap index adjustment filed by letter (in which SWBT reflected full SFAS-106 amounts, as opposed to the TBO amount only) following the court's remand of the January 22, 1993 OPEB Order.

The Godwins Study demonstrates that under very conservative assumptions, the GNP-PI will eventually rise by at most 0.0124% as a result of the adoption of SFAS-106 accounting. The exogenous amount originally filed by SWBT in June of 1992 contained explicit reductions -- based on the Godwins Study -- that

were more than sufficient to assure the Commission that all potential double counting in GNP-PI, the inflation adjustment in the LEC price cap plan at the time, was completely removed.

As stated in Attachment A to the USTA Direct Case, the original Godwins Study is still valid for calculating the extent to which the cost increases engendered by SFAS-106 will be recovered through the GNP-PI element of the Commission's price cap plan. Attachment A, a new affidavit from Peter Neuwirth, one of the original co-authors of the Godwins Study, and Andrew Abel, Ph.D., confirms that the Godwins Study estimate of the impact of SFAS-106 on the GNP-PI and of the percentage recovery of the price cap LECs additional costs incurred by their adoption of SFAS-106 are still reasonable. In the affidavit, Neuwirth and Abel explain that the original Godwins Study used a macroeconomic model that indicated that, in response to the impact of SFAS-106, the wage rate in the national economy will, over time, reduce in relative terms by 0.93%. If a price cap LEC were able to achieve this full reduction, it would finance 14.5% of its additional SFAS-106 costs. However, this macroeconomic adjustment is unlikely to be completed within a year, and may indeed take a few years to complete. Thus, during 1993, the fraction of additional SFAS-106 costs to be financed by relative reduction in wages is likely to be less than 14.5%. This calculation was extended to determine a "best estimate" impact. This "best estimate" was determined to be that 12.7% of the price cap LECs' additional costs would be recovered

through the combination of GNP-PI increases in wage rate reductions.

Neuwirth and Abel also state that sensitivity analyses requested by FCC staff have now been accomplished. The comprehensive sensitivity analysis provides an additional degree of comfort that the baseline results are, in fact, conservative.

Thus, Neuwirth and Abel conclude that the original study most likely has overestimated the impact of SFAS-106 on the GNP-PI.

An example of the extreme conservatism exercised by the authors of the Godwins study is the selection of the price elasticity of demand used in macroeconomic analysis. The Godwins Study describes this conservatism as follows:

The price elasticity of demand of 1.5 is probably too high, but it was chosen because experimentation with the model indicated that the impact of SFAS 106 on the GNP-PI increases when the price elasticity of demand increases. Thus, using a value of 1.5 most likely overstates the impact of the GNP-PI.³¹

B. Macroeconomic Models

Paragraph 25 of the Designation Order asks that parties relying on a macroeconomic model describe and document the model and provide other relevant information associated with the model, including any sensitivity analyses performed. Attachments A-F of the USTA Direct Case provide an exhaustive documentation of the Godwins Study methods, including a detailed description of the macroeconomic portion of the analysis, and the results of several different sensitivity analyses. Attachment A of the USTA Direct

³¹ USTA Direct Case, Attachment C (Godwins Study), p. 29.

Case is an Affidavit of Peter Neuwirth and Andrew Abel, the authors of the original Godwins Study. In that Affidavit, Neuwirth and Abel explain the relevance of the various results from the sensitivity analyses originally performed by the authors of the study and the sensitivity analyses subsequently required by the Common Carrier Bureau.

Importantly, it is not proper to use sensitivity analysis to determine either best estimates or reasonable conservative estimates; the sensitivity analyses performed by the authors of the Godwins Study are tools that demonstrate the robustness of study methods to wildly extreme parameter values. Specifically, the Godwins Sensitivity analysis that was performed under the specific directions of the Common Carrier Bureau only serves to demonstrate that extremely unreasonable assumptions yield extremely unreasonable results. This fact is supported by Attachment F of the USTA Direct Case submission.³²

C. Actuarial Valuation

Paragraph 26 of the Designation Order asks for a complete copy of the actuarial reports and studies used to determine SFAS-106 amounts.³³ A copy of SWBT's actuarial report, prepared by Towers Perrin, the independent actuarial firm used by SWBT, is

³² See, USTA Direct Case, Attachment A, Affidavit of Peter Neuwirth and Andrew Abel, pp. 2-3; and USTA Direct Case, Attachment B, "Best Estimate Increases TELCO's Unrecovered SFAS 106 Costs," by Randy Cosby, pp. 3-7.

³³ For purposes of this question SWBT has assumed that the Designation Order refers to actuarial reports used to determine 1993 SFAS-106 amounts since these reports formed the basis of the amounts filed in SWBT's tariffs.

included as Attachment 5. Included in the report are all assumptions utilized in the study, including each of the specific assumptions requested in the Designation Order. SWBT has excluded from the copy provided to the Commission pages that contain information specific only to SBC's nonregulated subsidiaries.

Specifically included are the assumptions on the following items that were specifically requested (also, listed in parentheses are the terms used in SWBT's valuation, if those terms are different from those used in the Designation Order): time value of money (discount rate),³⁴ expected rate of return on plan assets (long-term asset return rate),³⁵ participation rates,³⁶

³⁴ The discount rate used in the actuarial study was 7.5% per year, compounded annually. This rate was developed in compliance with the provisions of paragraph 31 of SFAS-106 and was made in reference to the return on high-quality fixed-income investments currently available which have cash flows that match the timing and amount of expected benefit payments, as required by SFAS-106.

The rate is the same as that used in SWBT's pension calculation and reflects SWBT's best judgment with regard to the appropriate time value of money over the period.

³⁵ SWBT assumed a long-term rate of return on plan assets of 8.0%. This rate was selected based upon expected future rates of return which could be reasonably expected to be realized in the various investment markets.

The rate was selected using the guidelines established in SFAS-106, as well as SFAS-87, Employers' Accounting for Pensions, and is consistent with that used in SWBT's pension cost valuation.

³⁶ SWBT has a contributory plan, in that the plan has a defined dollar benefit cap per retiree which when exceeded in any given year will trigger retiree contributions. The participation rate used in the valuation is 100% based on SWBT's current experience. This participation rate assumption will be reviewed in the future as more experience under the benefit cap becomes available, as required under SFAS-106 and GAAP. The defined dollar benefit cap has been accounted for in the actuarial analysis and has reduced the total SFAS-106 expense.

retirement ages (annual rates of retirement by age, sex and length of service),³⁷ per capita claims cost by age (retiree annual claims cost by age, before AT&T reimbursement),³⁸ health care cost trend rates (medical trend rate and annual increase in health claims),³⁹ salary progression (annual rates of salary increase by age),⁴⁰ and the probability of payment,⁴¹ turnover (annual rates of employee separation from service by age and sex), dependency status (percentage of active and retired employees married by age and sex), mortality (annual rates of mortality by age and sex). Also

³⁷ The retirement assumptions used by SWBT are reasonable because they were based on SWBT's 1991 six-year experience study (covering the period 1985-1990), modified to reflect 100% retirement when first eligible after age 65, as required by SFAS-106.

³⁸ The per capita claims cost by age used by SWBT are reasonable because they are based on a detailed evaluation of SWBT's recent experience.

³⁹ Short-term health care cost trend rates are reasonable because they are based on recent SWBT retiree-specific experience. In 1993 health care inflation is assumed to be 11% to 12%. Intermediate-term health care cost trend rates (1994-2004) assume a gradual reduction until reaching 6% in the year 2005. Long-term health care cost trend rates are set at 6% in a comparable manner to total spending in the U.S. economy (as measured by nominal gross domestic product) which is assumed to grow at 5.5%. Thus SWBT's assumptions portray a highly significant curtailment of health care inflation rates.

⁴⁰ The only SWBT retiree benefit which is pay related is life insurance. Therefore, salary progression data are irrelevant to the vast majority of SWBT's SFAS-106 cost calculations. For use with the life insurance analysis, SWBT has based its salary progression on SWBT's 1991 five-year experience study (covering the period 1986-1990).

⁴¹ The probabilities of payment used by SWBT are reasonable because they are based on standard mortality and withdrawal tables reflective of tables weighted by SWBT's own experience.

reimbursements.⁴² Assumptions on medical reimbursement rates are not provided as an explicit assumption was not made in SWBT's actuarial valuations.

Paragraph 27 of the Designation Order asks for all options provided by actuaries from which information was selected to derive SFAS-106 amounts, including ranges of data on the ages of the workforce, the ages at which employees will retire, the gross eligible charge table by age, and the length of service of retirees.

Towers Perrin did not submit options to SWBT for selection. The data included in the Towers Perrin valuation came from two basic sources: (1) SWBT-specific census data; and (2) SWBT-specific experience studies.

SWBT-specific census data was used for the employee and retiree census, by age, sex, length of service and annual salary. SWBT-specific data determined by SWBT experience studies was used for mortality, retirement, separation from service and salary increase.

⁴² SWBT's SFAS-106 valuation that served as the basis for both its 1992 Direct Case and its 1993 Annual Tariff Filing includes the effects of a benefit cap that significantly reduces the SWBT exogenous amounts. The Commission recognized that benefit caps can significantly reduce estimated OPEB accruals and the resulting exogenous amounts for SFAS-106. (January 22, 1993 OPEB Order, at para. 54). For active employees, SWBT's actuarial valuation assumes a defined dollar benefit cap on health care benefits which is very conservative and which results in much lower SFAS-106 costs than would be the case if no benefit cap were assumed. The effect of the 0% cap is to presume that SWBT's future retirees will pay for 50% of their estimated health care cost by the year 2005. This effect is assumed to continue to grow, so that each year after 2005, future retirees are assumed to pay an increasing share, above 50%.

Thus, data on the age of the workforce was based upon actual employee/retiree census information provided by SWBT to the actuary. Separation, retirement and mortality rates were established using SWBT-specific historical experience studies.

Although SWBT's actuary uses a net eligible charge method rather than a gross eligible charge method (as referenced in the Designation Order), there were no options from which to select. The net eligible charge information was based on SWBT's actual experience.

As a result, Towers Perrin did not present SWBT with options. Towers Perrin was required by SWBT to present and justify all assumptions used in the SWBT-specific SFAS-106 actuarial valuation study.

For comparison purposes, and as requested by the Commission, SWBT provides the actuarial assumptions and data used for SFAS-112 calculations as Attachment 9. SWBT adopted SFAS-112 accounting for FCC regulatory purposes⁴³ and external financial reporting purposes effective January 1, 1993. SWBT accounted for SFAS-112 in compliance with RAO Letter 22 and recognized the transition obligation in Account 6728, Other General and Administrative, upon adoption of SFAS-112 for regulatory accounting purposes in June 1993.

The Designation Order also asks for information on what adjustments carriers have made to their SFAS-106 amounts for

⁴³ RAO Letter 22, released June 17, 1993, provided the authority for SWBT to adopt SFAS-112 accounting for FCC regulatory purposes effective in 1993.

downsizing in the workforce that have occurred since the adoption of SFAS-106. This question may not be relevant. SWBT has consistently requested exogenous treatment for the increased costs that must be recognized as a result of the SFAS-106 accounting change. The amount of that difference is the difference between SFAS-106 costs at the time of adoption and pay-as-you-go costs (either at the time of adoption or at the time the initial price cap rates were established).

Since there has been no explicit method to recover the growth in pay-as-you-go OPEB costs since the inception of price caps for SWBT, SWBT could reasonably request exogenous treatment of the full difference between the pay-as-you-go costs in SWBT's 1990/91 tariff year costs and the SFAS-106 costs at 1993 adoption. However, consistent with SWBT's conservative approach, SWBT has requested only the difference between 1993 SFAS-106 cost and 1993 pay-as-you-go costs (which was reduced further by a drastic overestimate of the inflation double count).

If SWBT experiences downsizing more rapidly than expected in its valuation, then the number of retirees typically rises⁴⁴ and the liability for current retiree nonpension benefits rises accordingly. At that point it is immaterial whether the pay-as-you-go costs for OPEBs rises more rapidly or less rapidly than the estimate of SFAS-106 costs. The change in accounting to SFAS-106

⁴⁴ To the extent that downsizing involves any employees eligible for retirement, downsizing will increase the number of retirees receiving OPEBs. It will not decrease the number of current retirees receiving OPEBs.

accrual accounting that caused SWBT's accounting-based cost of service to rise appreciably -- the exogenous event in this case -- has already occurred. Importantly, there is absolutely no mechanism in the price cap plan that has adjusted or will adjust interstate rates for increases in OPEB pay-as-you-go cost caused by more rapid retirements; as a result, the Commission should make no reductions in exogenous amount for any future acceleration of retirements.

Because the FASB and the Commission require that SFAS-106 methods be used to determine OPEB expenses, a significant amount of natural downsizing is included in SWBT's SFAS-106 valuation. SFAS-106 requires what is known as a closed group actuarial valuation. In a closed-group valuation, no new hires or replacements for employees who leave the company for any reason (retirement, separation, layoff, death or other reason) are included in the valuation. The closed-group valuation for 1993 reflected 49,892 active SWBT employees in 1993. The valuation projected this group to decrease to a 1998 employee level of 41,056, a natural reduction of 18% from 1993 employment levels. The valuation further projected the group to decrease to 31,616 employees in the year 2003, a natural reduction of 37% from 1993 employment levels. Thus, the requirements of SFAS-106 result in a very substantial amount of natural downsizing to be reflected in the valuation and, therefore, in SWBT's exogenous amount.⁴⁵ A further display of the

⁴⁵ The closed-group method causes the number of retirees to also be substantially below the levels that would be included in an "open-group" method where new hires replace "natural" force

magnitude of the natural downsizing reflected in SWBT's actuarial valuation is included as Attachment 10.

No additional assumptions about expected downsizing above the amounts included in the natural downsizing effects required by SFAS-106 methods were reflected in SWBT's exogenous amounts.

D. Medical Care Inflation

Paragraph 28 of the Designation Order states that since part of the growth in Gross Domestic Product Price Index (GDP-PI) presumably occurs due to growth in medical costs, the Commission seeks information on what adjustments, if any, should be made in the exogenous amounts to avoid double-counting.

SWBT continues to rely on the Godwins Study, which removes from the exogenous amount an over-estimate of the double-count in the inflation measure used in the price cap formula.⁴⁶ Thus, SWBT has already removed all possible double-count in the inflation measure from its exogenous amount.

The Godwins study examined the effect on GNP-PI, which was the inflation adjustment in the LEC price cap plan at the time of the exogenous adjustments. In the LEC Price Cap Review Order, the Commission changed the inflation measure in the LEC price cap plan to the GDP-PI. One of the fundamental reasons that the Commission was willing to make this change was that there is

reductions, thereby eventually generating additional retirees.

⁴⁶ Utilizing the results from the Godwins Study, SWBT removed 0.7% of the incremental SFAS-106 amount to calculate a conservative estimate of the exogenous amount. SWBT made further voluntary reductions in its exogenous amount for a potential reduction in the national average wage rate, as described below.

virtually no difference between the numerical results of using the GDP-PI compared to the GNP-PI.⁴⁷

This question may also be irrelevant as to the event for which SWBT seeks exogenous treatment. SWBT has never sought exogenous treatment for future increases in medical care costs. SWBT has sought exogenous treatment for the effects of the mandated change to SFAS-106 accounting.

Importantly, medical care inflation affects both pay-as-you-go costs and SFAS-106 costs. There is no mechanism in price cap regulation to adjust for the medical care inflation in pay-as-you-go costs; there should not be a reduction in the exogenous amount for the fact that medical care inflation has historically been above overall inflation. Also, the SFAS-106 accounting principles require that future estimated medical care costs be discounted by a nominal discount to remove the effects of overall inflation from the calculations. Thus, the existence of medical care inflation in the underlying projections utilized for the SFAS-106 valuation are removed by the discounting process and are not double counted in the price cap formula.

SWBT's interstate access rates had historically been established based on accounting costs (as did the other price cap LECs). SWBT's rates under ROR regulation were established using pay-as-you-go OPEB costs and these costs were the basis for SWBT's initial price cap rates. SWBT has sought exogenous treatment for

⁴⁷ See USTA Direct Case filed this date, Attachment A, p. 5, footnote 2; and SWBT Comments, Appendix GNP, "GNP-PI Versus GDP-PI: 1982 to Present," filed May 9, 1994, CC Docket 94-1.

the fact that its interstate access rates had been established using OPEB accounting rules that caused cost levels to be dramatically understated. Thus, the Commission's strict adherence to OPEB accounting costs on a pay-as-you-go basis caused true economic cost of nonpension retiree benefits and interstate access rates to be understated. It was for this very occurrence that exogenous treatment of accounting changes was included in the Commission's price cap plans.

Closely related to this issue, a party to the past SFAS-106 tariff investigations had suggested that the growth rates in GNP-PI (in GDP-PI now) be reduced to remove the entire effect of presence of medical care sector in the U.S. economy.⁴⁸ This is a totally flawed view of the workings of the macro economy and the operation of price cap regulation. Changes in the overall inflation trend may not result from the sum of the individual component prices in the economy; they may instead result from U.S. monetary and fiscal policies, altered by the collective effects of external demand and supply shocks (like war or crude oil embargoes). Under this relatively well-accepted view, it would be completely inaccurate and wholly inappropriate to carve out a sector of the economy and presume that inflation must be zero in that sector.

⁴⁸ See MCI Comments, CC Docket No. 92-101, filed June 1, 1992, p. 31. This wrong "solution" was addressed by the authors of the Godwins Study in USTA Reply Comments, CC Docket No. 92-101, filed July 31, 1992, to be included in the USTA Direct Case filed on this date, Attachment E, "Supplemental Report: Responses to Objections Raised Regarding Original Study," pp. 6-7. See also, Rebuttal of SWBT, filed July 31, 1992, in CC Docket No. 92-101, at p. 10.

A further flaw in this misplaced suggestion is the fact that underlying inflation expectations are typically reflected in the pricing decisions of many sectors of the economy. Estimate of underlying or "core" inflation are reflected in cost-of-living adjustments and wage and salary negotiations between employers and employees. As a result, overall inflation, including the existence of medical care inflation, is included in the wage and salary sector of the economy and the carriers. Inflation expectations are also reflected in interest rates and numerous asset pricing decisions throughout the economy. None of these expectations would be accurately reflected by carving out and discarding the medical care sector of the economy.

For all of these reasons, there is no legitimate means to reduce the GDP-PI to remove medical care inflation, and this portion of the Designation Order should be considered irrelevant.

E. Wage Adjustment

Paragraph 28 of the Designation Order further asks parties to describe and quantify any wage changes that will be reflected in the GDP-PI that are expected to occur as a result of the introduction of SFAS-106 and discuss what adjustment, if any, should be made in the exogenous amounts for this change.

Based on the Commission's rules and the direction provided by the Court, there should be no adjustment of the exogenous amount for any future expected changes in the national average wage rate. The Commission's rules treat changes in wages and salaries as endogenous. The Commission could not now mandate

exogenous treatment of wage rate changes simply because the Godwins study adjustments utilized by the LECs have chosen to include them in their proposed exogenous amounts.

SWBT has consistently volunteered to make a wage rate adjustment to its exogenous amount with the full knowledge that such a reduction in its exogenous amount is not called for by the Commission's rules.⁴⁹ SWBT has done so to clearly demonstrate the extremely conservative nature of its exogenous amount.

The Godwins Study analysis demonstrates that based on the GNP-PI effect, 99.3% of the price cap LECs' additional costs are unrecoverable from the price cap formula. However, the macroeconomic analysis in the Godwins Study determines that the national wage rate might be reduced by a total of approximately 0.93% over the long term because of a reduction in the use of labor relative to use of capital and other nonlabor inputs.⁵⁰ The Godwins Study states:

The Macroeconomic Analysis finds that the national wage rate would eventually be 0.93% lower than it would have been in the absence of SFAS 106. If TELCO were able to benefit from a similar reduction in its wage rate, such a reduction would recover an additional 14.5% of TELCO's direct SFAS 106 costs.⁵¹

⁴⁹ See Rebuttal of SWBT filed July 31, 1992 in CC Docket No. 92-101 at p. 18.

⁵⁰ A detailed explanation of the estimation of the possible reduction in national average wage rates is contained in USTA Direct Case, Attachment C (Godwins Study), especially pp. 5, 11, 32-33. See also, USTA Direct Case, Attachment B (Cosby Narrative), p. 5; and USTA Direct Case, Attachment A, p. 3.

⁵¹ USTA Direct Case, Attachment C (Godwins Study), p. 5.

F. Compensation Per Employee

Paragraph 29 of the Designation Order asks that each carrier provide information on its average total compensation per employee and the amount of this compensation represented by OPEBs. The order also asks for similar data for the economy as a whole for comparison.

SWBT data on compensation for 1992, 1993 and 1994 are included here as Attachment 11, page 1. SWBT compensation per employee for 1993, the year that SWBT implemented SFAS-106 accounting, is \$52,798. This amount includes wages, salaries, pensions, the employer share of FICA, other compensation and SFAS-106 accrual accounting for postretirement benefits. Compensation per employee increased by 13.9% from 1992 to 1993, almost exclusively as a result of the adoption of SFAS-106.

Comparable data for wages, salaries, employment and some benefits data are available from government data sources and are presented on page 2, Attachment 11. For comparison purposes, SWBT suggests that the Commission consider using data gathered by the U.S. Department of Labor, Bureau of Labor Statistics and the U.S. Department of Commerce, Bureau of Economic Analysis.

Paragraph 30 of the Designation Order states that "the accruals for OPEBs generally represent non-cash expenses that may never be paid." The Order further asks whether provisions have been made "to return to ratepayers the over-accrual, if any of the non-cash expenses if exogenous treatment is given for these amounts."

The Designation Order, conjectures that OPEB expenses "may never be paid." This statement again implicitly attempts to shift the criteria for exogenous treatment to "control" over the underlying costs. The "control" criteria for exogenous treatment, as specified in the Commission's rules and as affirmed by the court, is whether carriers have control over the SFAS-106 accounting change. Thus, it is immaterial whether the Commission's unsupported conjecture regarding over-accruals is accurate or not because paragraph 30 presumes an incorrect perspective on the Commission's control criteria.

Under protest, and pending appeal, SWBT's 1993 Direct Case discussed SWBT's willingness to provide the Commission an annual OPEB Exogenous Tracking Report. SWBT signalled its willingness to consider undertaking the cost and burden of an annual tracking report in the specific situation where the exogenous amount was retained in carriers' price cap indexes until the amortization of TBO expired. Earlier this year, however, the Commission ordered that all SFAS-106 amounts be removed from the price cap LECs' price cap indexes. SWBT has filed a Petition for Review with the U.S. Court of Appeals regarding this Order. At this point, SWBT questions the validity of an OPEB tracking report.

SWBT has made no changes in OPEB offerings to employees since 1993, when SWBT adopted SFAS-106 accounting. SWBT will provide any new contracts with employees and their representative unions once they are negotiated and approved.